



PRESIDENCY Summary Note: Risk Retention – Responses to EP Proposal

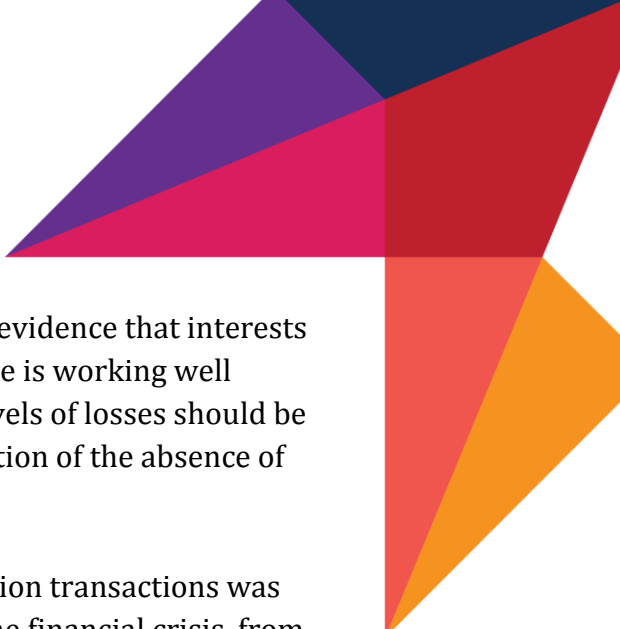
This non-paper aims to summarise and present in a very concise manner the main arguments raised during Council discussions in relation to the European Parliament (EP) proposal and subsequent non-papers with regards to the subjects of risk-retention and macro-prudential measures. The arguments presented in this non-paper have already been raised by the Presidency in previous trilogue meetings and are being reproduced in written format to facilitate future discussions on this topic.

Summary of key arguments

Council recognises the concerns and the good intention of the EP on the proposal, however, Member States raised several concerns on this matter.

In the first instance, there is general recognition within Council that risk retention is not a macro-prudential tool but an alignment of interests. Risk retention is primarily intended to align interests between originators and investors. To note as well that risk retention is not the sole method by which alignment of interest can be achieved (ex. retention of excess spread, positioning of manager or servicer fees in the deal cash flow waterfall, rights and obligations of the servicer and trustee, etc.).

In general, the discussion on misalignment incentives has not yet been supported by any evidence that this has become a feature of the European securitization market post-financial crisis. For instances, the SAFE White Paper largely based the analysis on academic studies that appear to be drawing on market data from the US. However the European markets have a different performance record (in particular throughout the financial crisis) than the US markets with low level of defaults and losses registered by European securitisation products, as also reflected in the Commission Impact Assessment accompanying the STS Proposal¹. It was also mentioned that while there were low defaults, market prices were stressed for a long period following the financial crisis indicating loss of confidence in the product. It should be noted though that market prices adjusted

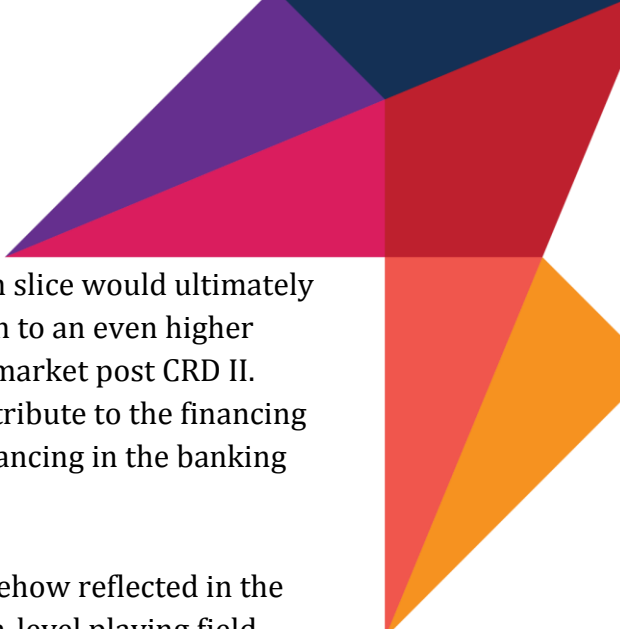


subsequently and returned to normal levels which is evidence that interests are still properly aligned and the risk retention regime is working well throughout the whole life of the products. The low levels of losses should be evidence of good origination standards and an indication of the absence of “cherry-picking” bad loans to securitise.

Furthermore, the alignment of interests in securitisation transactions was targeted by a much broader regulatory response to the financial crisis, from new risk weightings calibrations and liquidity requirements, improved accounting standards, higher origination standards, better regulation of credit rating agencies (CRAs) just to name a few. Thus, the whole spectrum of prudential regulation enacted in response to the financial crisis should already safeguard for the functioning of a securitisation market “in bad times”.

Nonetheless, the Council compromise, goes further to ensure further safeguards to align incentives between originators and investors. Under Article 5(a) and 8 (6) of the STS Regulation, the Council added safeguards on ‘criteria for credit granting’ to avoid possible ‘originate-to-distribute’ problems that were the heart of the US subprime crisis. Under Article 16(2) of the STS Regulation, competent institutions are required to regularly review processes and mechanisms to correctly measure and retain the material net economic interest on an ongoing basis and the gathering and timely disclosure of all information to be made available in accordance with [...] the credit-granting criteria in article 5a. Even under CRR-regulation, for example under Article 243(2c), both the EC-proposal, the Council general approach and the EP-proposal put forward criteria that limit the extent to which potentially risky exposures can be secured in an STS-transaction (maximum risk-weights are introduced).

At this stage, it is worth to reiterate the main aim of the STS Regulation, that of revitalising the EU securitisation market to contribute to improving the financing of the economy as part of the CMU. The Council expresses concerns that the impact of the proposed initiatives, as addressed by this non-paper would be contrary to the objective of the proposed regulation. The EP non-paper acknowledges that the proposed initiatives would have a negative impact on the collateralized loan obligations (CLOs) market, by disrupting the business model and viability of CLOs, who finance SMEs and the real economy, through the increased and excessive burden placed upon them. A large segment of CLO transactions is currently based on vertical



risk retention model. Increasing the vertical retention slice would ultimately deter most new entrants on the market – contribution to an even higher significant concentration of CLO managers in the EU market post CRD II. This is highly undesirable since CLO participants contribute to the financing for European companies that often struggle to get financing in the banking sector.

Another crucial point raised within Council (and somehow reflected in the comparison of the Safe White Paper) is the already un-level playing field between Europe and other non-EU jurisdictions that do not impose mandatory retention of any level for their domestic securitisations, nor did they impose retention requirements for foreign securitisation purchased by their domestic investors. Europe is the only main jurisdiction where risk retention fully applies. The proposed amendments would put European securitisation at a competitive disadvantage internationally. It had been stressed numerous times within the Council discussion that the current risk retention framework, developed by BCBS and IOSCO, has been deemed sufficient on a global scale. Accordingly, Council did not find the information supplied so far as sufficient to merit deviation from the global standards.

Finally, Council expressed serious reservations at the proposed amendments towards revisiting the rates in future, with assessments every two years. This would inevitable introduce excessive uncertainty into the securitisation market, hampering the stability of the product. This is because it would be very difficult (if not impossible) for financial institutions to build a reliable medium term funding model based on assumptions that can change on a two-yearly cycle. These macroprudential proposed rules would further put securitisation at a disadvantage towards other financial instruments such as covered bonds. There are implications for the funding costs associated with securitisation, and may therefore run counter to overall objective of this regulation which is to revitalise EU securitisation markets.
